Is buying a distressed company a bargain or burden?

By Adrian Dommisse

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Every now and then an opportunity comes along that looks very hard to resist. If you're a seasoned entrepreneur, this might come in the form of a company that, although in such distress that the shareholders want out, still has genuinely valuable assets or a viable business model.

Buying the company at a discount and then selling off its assets is one way to turn a profit from such a situation. Another option is to buy the company and turn it around. This can be especially tempting when the company has liabilities that may prevent it from showing a profit for some time, which can translate into a considerable tax advantage.

Deals like this are not for the inexperienced or fainthearted - or for those who tend to get carried away by their own enthusiasm. Unfortunately, this perfectly describes most entrepreneurs - seeing the upside and getting swept up in your own enthusiasm is practically part of the job description. This is why you need a team of lawyers, accountants and other advisers on your side to provide a reality check.

The first rule of buying a company in distress is: never, ever go soft on due diligence. Hire the most paranoid team you can find and have them tear the place apart. There are bound to be skeletons in various closets, and you want to shine clear, cold daylight on all of them.

The primary objective of the due diligence is to make sure there are no liabilities in the business that you're unaware of, and no unquantifiable risks. It's always the stuff you don't know about that will trip you up, so do whatever is possible to ensure you know everything.

Beware of any material risk

We usually ensure that a Purchaser has recourse to the amount paid to the Sellers (such as by retaining all or a portion of the purchase price, or placing it on escrow). The big thing to beware of is any material risk that could expose you to a liability greater than the price you're paying for the company. You can always ask for warranties from the sellers that they haven't withheld any relevant information - but the warranty indemnity probably won't be more than the purchase price.

You also need to beware of any evidence that the previous management has not been running the company properly in the past. If there is any suggestion that they've been playing fast and loose, SARS can re-open tax assessments from previous years - and then the entire basis for your purchase could be undermined.

Which brings us to the second rule of buying a company in distress: get the best tax advice you can afford. The really interesting structures often have tax advantages - and if your goal in buying the company is to enjoy the tax advantage, you had better be sure it really exists.

If the due diligence confirms there is no SARS debt or other debt you can't compromise, and that you have identified all the risks -then there is a chance you have a real opportunity on your hands. If you are confident that you can turn the company around and make it work, the rest is up to you.

ABOUT ADRIAN DOMMISSE

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